APPENDIX

PROCEEDINGS IN THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

CAUSES ARGUED AND SUBMITTED

February 15, 1966

Before: Phillips, Edwards and Celebrezze, Circuit Judges.

These causes are argued by W. Stuart McCloy for petitioners and by Lawrence B. Silver for respondent and are submitted to the Court.

JUDGMENT

April 1, 1966

No. 16,436

Before: Phillips, Edwards and Celebrezze, Circuit Judges.

On Petition to Review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

No costs awarded. Rule 23(4).

Entered by order of the Court.
/s/ Carl W. Reuss, Clerk

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/s/ Carl W. Reuss, Clerk

PETITIONS FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

Before: Phillips, Edwards and Celebrezze, Circuit Judges.

Per Curiam: Petitioners in these two cases appeal from adverse decisions by the Tax Court finding deficiencies in income tax for certain taxable years. The gross factual situation involved in this appeal does not present any dispute: but petitioners claim that certain income realized by them as a result of covenants not to compete should be taxed as capital gains. The covenants not to compete were executed by Louis A. Klitzner and

Harry F. Leshnower as a part of the transaction in which they sold their linen supply business in Memphis to the National Linen Service Corporation.

The Commissioner contends (and the Tax Court so held) that the funds derived from the covenants not to compete should be taxed as ordinary income.

The undisputed facts in this case clearly showed that the purchase of this linen supply business was the result of hard and extensive bargaining wherein petitioners were capably and effectively represented by persons fully familiar with the tax consequences of the negotiations. Early in the negotiations National Linen Supply Company made it clear that it would insist upon the execution of covenants not to compete by the two principals involved here. This record leaves no doubt that the covenants not to compete had real economic value for the purchaser.

Ultimately the price for these covenants was set at $375,000, payable to Klitzner and Leshnower in accordance with their respective interests over a period of ten years. The consideration for the covenants not to compete was recited in a separate contract by which those covenants were made binding. The Tax Court found these facts and many others relevant to support of its ultimate decision in a lengthy set of findings of fact which we have reviewed carefully and which we cannot declare to be clearly erroneous. *Commissioner* v. *Duberstein*, 363 U.S. 278 (1960).

In a recent decision of this court the factual situation was closely parallel to the facts with which we deal here. In determining that compensation for several covenants not to compete should be held ordinary income for tax purposes, this court said:

> "This record demonstrates that there was arm's length bargaining; that the Montesis were capably represented and were under no economic or other pressure to accept contractual terms which placed them at an unfair position from a tax point of view; that the contracts not to compete were of significant value to National Tea, and that the parties set a separate valuation on them. This record taken as a whole does not convince us (as it did not convince the Tax Court) that the $250,000 value which the parties themselves set on these contracts was unrealistic." *Montesi* v. *Commissioner*, 340 F.2d 97, 99 (C.A. 6, 1965).

With only the names and amounts changed, this same statement is applicable to the present case.

We agree with the memorandum opinion of the Tax Court and affirm the decisions entered by it in the two cases now before us on appeal.

The controlling law of this case is, of course, federal law. *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945).

We find no error in the rulings of the Tax Court admitting or excluding evidence which deprived appellant of "substantial rights." Rule 61 Fed. R. Civ. P.

Affirmed.

PETITION FOR REHEARING

This Honorable Court filed a Per Curiam Opinion on April 1, 1966, affirming the decisions of the Tax Court of the United States upon the authority of *Commissioner* v. *Duberstein*, 363 U.S. 278 (1960); *Montesi* v. *Commissioner*, 340 F.2d 97 (C.A. 6, 1965) and *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945).

I. THE UNDISPUTED FACTS.

Petitioners respectfully urge this Honorable Court to reconsider its opinion upon the authority of the following cases:

1. *Fox & Hounds, Inc.*, 21 T.C.M. 1216 (1962).

In the sale of a restaurant the seller did not concern himself with a covenant which the purchaser did want for tax purposes. Good will was a factor in the negotiations. The covenant was held to be a capital asset.

The undisputed facts are as follows:

At R. 186a-198a Petitioners' representative testified to the identical effect. So did the Purchaser's representative at R. 207a, 208a. The undisputed facts established that all negotiations ceased with the agreement dated May 26, 1958, known as Joint Exhibit 23-W. (R. 186a-188a, R. 207a-208a). The Joint Exhibit 23-W bears upon its face the results of these negotiations and evidences the agreement of the parties. It shows the change and interlineation to "cash" (R. 88a, 189a) (as well as in the original exhibits before this Honorable Court), and the complete disclaimer of allocated asset values. (R. 94a, 207a, 219a, 220a).

2. *Radio Medford, Inc.*, 150 F. Supp. 641 (1957).

In the sale of a radio station the purchaser sought to reach an agreement with the seller to allocate by agreement a value to a covenant and no such agreement was consented to by the seller or ever reached by the parties. The allocation of value to the covenant was held to be the unilateral action of the purchaser.

The undisputed facts are as follows:

At R. 187-a-188a Petitioners' representative testified no agreement was reached as to the allocation of values of

any assets. At R. 220a, 221a, the purchaser's representative also testified to the same effect. Joint Exhibit 23-W at R. 88a-94a is the best evidence of these undisputed facts.

3. *Masquelette's Estate et al.*, 239 F.2d 322 (C.A. 5, 1956).

> In the sale of partnership interests by two partners the undisputed facts established that the partners sold a going business, including substantial good will, as evidenced by their written sale agreement. The Tax Court was reversed as to its interpretation of the written agreement in the light of the undisputed oral testimony.

The undisputed facts are as follows:

At R. 156a, 173a, 186a, 187a, 194a, 197a, Petitioners and their representative established that they sold partnership interests in a going concern, including substantial good will. The purchaser's representative also establishes these facts at R. 220a, 221a. No less than six (6) exhibits including Joint Exhibit 23-W also establish these facts.

Request for Rehearing

In the opinion of the Tax Court, the facts found to be undisputed by this Honorable Court are utterly without significance unless the record supports these ultimate facts: (1) The covenant had real economic value or a real relationship to the individual personal services of the Petitioners, negatively or affirmatively, rendered; (2) the covenant was for the negative or affirmative rendition of those services and unrelated to the good will acquired by the purchaser; (3) the parties to the sale mutually agreed upon its separation and its value unrelated to the good will of the business.

Petitioners in their reply brief (pp. 2-3) pointed out to this Honorable Court that Respondent had not complied with Rule 16(4)(b) of this Court.

Based upon the undisputed facts referred to above, there is no support in the record for any inference or finding that the Petitioners considered the covenant significant or of real economic value to them other than as deferred payments of purchase price as to which interest was a definite factor. (R. 219a). Realistically, parties to sales transactions do not consider interest in arriving at compensation for personal services. The original documents filed in this Court show clearly the interlineation of "cash" before "consideration" as well as the sellers' clear and unequivocable disavowal of the purchaser's value allocations. The unilateral allocation of value out of an agreed overall purchase price, has no significance other than as a "mere formality" designed by the purchaser, not the seller, to make the transaction appear to be other than it was. *Court Holding Company* v. *Commissioner*, 324 U.S. 331 (1945).

The facts are undisputed at May 26, 1958, the date Joint Exhibit 23-W, the final agreement, was reached. A binding covenant was contained in that agreement as an integral part of the overall sale of the partnership interests in the going concern. What the purchaser did or arranged afterwards added nothing to the legal or binding effect of Joint Exhibit 23-W and the contained covenant which upon the undisputed evidence was the final contract between the parties.

In conclusion, it is not significant that parties to a sale are represented by capable or incapable representatives. The test is what did those representatives achieve at the bargaining tables as evidenced by their final agree-

ment. Was the final agreement the record of their professed intention and their respective skills. The purchaser testified no agreement was reached as to its values (R. 220a), that interest was a factor in the increase of $250,000.00 payable over a 10 year period to $375,000.00 (R. 219a-220a), that it drafted all of the documents.

Conflict with case of Masquelette's Estate et al. v. Commissioner.

Petitioners urge that there is a conflict between the decision of this Honorable Court in these cases and the decision of the Honorable Court of Appeals for the 5th Circuit in the case of *Masquelette's Estate,* supra. The Tax Court of the United States was clearly erroneous and without support in the record for its erroneous conclusions of law based upon its interpretation of the written contract in the light of the undisputed oral testimony.

II. THE LAW APPLICABLE.

Petitioner also respectfully urges this Honorable Court to reconsider its opinion upon the authority of the following case:

1. *Ullman* v. *Commissioner,* 29 T.C. 129, aff'd 264 F.2d 305 (C.A. 2, 1959).

The Tax Court (Opper, Judge) notes a distinction between the sale of a business by its direct owner on the one hand, where good will is the property of the vendor and his covenant may well be a contributing factor in the sale of the entire business, e.g. (individuals), citing *Aaron Michaels,* 12 T.C. 17; *Harold J. Burke,* 18 T.C. 77; (corporation) *Toledo Blade Co.* v. *Commissioner* (C.A. 6) 180 F.2d 357, affirming 11 T.C. 1079, certiorari denied 340 U.S. 811, and on the other, situations where the covenant is the personal agreement of individuals who, as such, have no direct proprietary right in the good will, citing cases relied upon in these appeals by the respondent.

Request for Rehearing

The undisputed facts are that the Petitioners were partners and sold their partnership interests in their business as a going concern.

It will be noted that in the *Ullman* case, supra, the covenants were given by stockholders who sold capital stock of their corporation.

The Tax Court, and now this Honorable Court, has by their decisions in these cases abolished the clear legal distinction between: (1) a sale of assets by a corporation certain of the officers giving separate covenants to the purchaser as in *Montesi* v. *Commissioner,* 340 F.2d 97 (C.A. 6, 1965); (2) a sale of corporate stock of a corporation whose officers give covenants to the purchaser as in *Toledo Blade Co.,* supra; (3) a sale of corporate stock of a linen service business by its stockholders who gave a separate covenant or covenants. *Andrew Newman, Inc.,* 16 T.C.M. 1018 (1957), and in *Ullman,* supra; and (4) a sale by individuals having a direct proprietary interest in the good will of their businesses sold as going concerns. *Aaron Michaels,* supra; *Faulkner,* 15 T.C.M. 175 (1956); and *Commissioner* v. *Morris Shapiro,* 125 F.2d 532 (C.A. 6, 1942).

Conflict with Michaels, Faulkner, Shapiro cases.

This failure to consider the legal distinction between the indirect, and the direct, proprietary interest in good will held by partners selling a going business as well as the undisputed evidence that the petitioners in these cases sold their partnership interests and not the partnership assets makes inapplicable the case of *Montesi* v. *Commissioner,* supra, and the language therefrom quoted by this Honorable Court and creates a conflict within this Honorable Court with the case of *Commissioner* v. *Morris Shapiro,* supra.

To demonstrate the error of the Tax Court, the attention of the Court is directed to R. 288a-289a where the Tax Court states that the Petitioners contended: (1) that they sold their partnership interest; and in the alternative, (2) that they in fact sold partnership assets. The Tax Court was confused because the Petitioner's contention was always that they sold interests which were capital assets, but, even so, in its opinion, it found (R. 291) ". . . it is true that under the offer and acceptance executed May 26, 1958, they sold their partnership interests to National . . ." Then the Court said, ". . . we are unable to find support in the record for their conclusion that the payments in question should be characterized as consideration therefor." This support was to be found: (1) in Joint Exhibit 23-W (R. 88a-94a); (2) in Mr. Haas' own admissions for the buyer which are in the record (R. 207a, 219a, 220a, 221a); (3) in Mr. Klitzner's testimony (R. 156a-157a); (4) in Mr. Leshnower's testimony (R. 173a); and (5) in Mr. Seidman's testimony (R. 186a-187a). The testimony is undisputed from both sides of the bargaining table and yet the Tax Court observed that it could not find any support in the record for such a conclusion. This was "clearly erroneous."

The Tax Court found that the Petitioners sold partnership interests (R. 291a) exactly as Petitioners contended. How then could the Tax Court find that the Petitioners sold specific assets at varying prices allocated by the purchaser in the face of Joint Exhibit 23-W which clearly states that Petitioners were selling their partnership interests and did not agree to the purchaser's evaluations of any assets or as Mr. Seidman also testified (R. 187a):

> ". . . it was a purchase of a partnership interest . . . we would not sign any such agreement unless we were permitted to take a complete disclaimer of the enumeration and listing of the values or even the enumeration of the type of assets that they were acquiring."

Mr. Haas, for the buyer, said this was all true (R. 220a, 221a). If the final agreement dated May 26, 1958, supported the conclusion, and the oral testimony of the parties supported the conclusion, then the Tax Court is without support in the record that assets were sold or that agreements were reached as to values and its opinion is not only "clearly" but is "comjletely" erroneous. It becomes obvious why the Respondent did not comply with Rule 16 of this Honorable Court as to facts or citations to the record in support of facts.

In conclusion, this Honorable Court cites *Commissioner* v. *Court Holding Company,* supra, decided after the rule of *Dobson* v. *Commissioner,* 320 U.S. 489, for the proposition that the controlling law of this case is federal law. This statement is taken to mean that the federal law designates what interests or rights, created by state law, should be taxed. Cf. *Goodwin* v. *Commissioner,* 201 F.2d 576 (C.A. 6, 1953). See also petitioners' main brief, pages 80-81, and petitioners' reply brief, pages 22-24. Federal law, and in particular Section 741 of the Internal Revenue Code of 1954, designates that sales of partnership interests are taxed as capital gains. If state law creates rights or interests which are subject to federal law, then it was not found by the Tax Court, and there is no evidence in the record to support such a finding, that the covenants here were in fact ancillary to the employment of the petitioners by the purchaser. It was quite obvious, upon the undisputed facts and the inclusion of the covenant in

the final agreement of sale (Joint Exhibit 23-W) as part and parcel of the sale of partnership interests, that the covenant was ancillary to the sale of those partnership interests. Accordingly, the *Court Holding Company* case is inapplicable, because there the Tax Court found that the corporation had in fact executed a sale of its assets, consummated by its stockholders. If applicable at all, it is to the action of the purchaser whose allocations and actions were "designed to make the transaction appear to be other than what it was." Where clearly erroneous findings are made the Tax Court may be reversed. Cf. *Commissioner* v. *Duberstein*, 363 U.S. 278 (1960); *Copperhead Coal Co., Inc.* v. *Commissioner*, 272 F.2d 45 (C.A. 6, 1959).

Wherefore, Petitioners respectfully pray that this Honorable Court will reconsider its opinion entered herein and rehear the cause, reversing the Tax Court and entering decision for the Petitioners.

Respectfully submitted,

/s/ W. Stuart McCloy
1701 First National Bank Building
Memphis, Tennessee

CERTIFICATE

I, W. Stuart McCloy, Counsel for Petitioners, certify that I have presented the above and foregoing Petition for Rehearing in good faith and not for the purposes of delay.

Memphis, Tennessee, April 15, 1966.

/s/ W. Stuart McCloy
Counsel for Petitioners

ORDER

May 6, 1966

Before: Phillips, Edwards and Celebrezze, Circuit Judges.

On consideration of petition for rehearing filed in the above-styled matter, the same is hereby denied.

Entered by order of the Court
/s/ Carl W. Reuss, Clerk

CERTIFICATE OF CLERK

I, Carl W. Reuss, Clerk of the United States Court of Appeals for the Sixth Circuit, do hereby certify that the foregoing is a true and correct copy of proceedings in the case of Louis A. Klitzner, et al. v. Commissioner of Internal Revenue, No. 16,436-7, as the same remains upon the files and records of said United States Court of Appeals for the Sixth Circuit, and of the whole thereof.

IN TESTIMONY WHEREOF, I have hereunto subscribed my name and affixed the seal of said Court at the City of Cincinnati, Ohio, this 14th day of June, A.D. 1966.

/s/ Carl W. Reuss
Clerk of the United States Court
of Appeals for the Sixth Circuit

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 417

LOUIS A. KLITZNER and ISABEL S. KLITZNER,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

HARRY F. LESHNOWER and RUTH S. LESHNOWER
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioners[1] sold their parnership interests in a linen rental and laundry business to the National Linen Service Corporation in 1958. The written con-

[1] Mrs. Klitzner and Mrs. Leshnower are parties only because they filed joint tax returns with their husbands for the years here in question. Their husbands will be referred to as petitioners herein.

tract provided for the sale of petitioners' partnership interests to National for $577,000 and stated that petitioners would enter into a non-competition agreement with National for the separate consideration of $375,000. A separate restrictive covenant was thereafter executed between petitioners and National. The Tax Court found that the restrictive covenant was separately bargained for, that it had been negotiated in order to prevent petitioners from re-entering the linen service business, and that payments received by the petitioners on account of the non-competition agreement were ordinary income (as the Commissioner contended) rather than capital gain (as petitioners argued). The court of appeals affirmed *per curiam* and denied rehearing. (R. 88a-94a, 113a-116a, 262a-295a; Pet. 2a-4a, 13a.)[2]

The decision below is correct, and there is no conflict of decisions or other ground for review.

1. Amounts received in consideration for the sale of a partnership interest are, in general, treated as capital gain; amounts received in consideration for a covenant not to compete—like payments for personal services—constitute ordinary income. Petitioners do not dispute these settled legal principles. Instead, they argue that the amounts here in controversy—which were designated by the parties' contract as consideration for the covenant not to compete—were actually paid as additional, disguised consideration for the sale of the partnership interests.

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[2] "R." references are to the appendix to the petitioners' brief in the court of appeals.

The contract between the parties separately states the specific amount to be paid as consideration for the partnership interests and the amount to be paid for the non-competition agreement (R. 88a-92a). Petitioners executed a separate document entitled "restrictive covenant" (R. 113a-116a). As the Tax Court observed (R. 292a), neither the language of the agreements nor the testimony lends any support to petitioners' argument that the payments received under the restrictive covenant were actually additional payments for the partnership interests. On the contrary, it is clear that the restrictive covenant had economic reality. The linen business depends to a large degree on personal contacts (R. 294a). Therefore, unless National obtained an effective covenant not to compete from petitioners, they would have been free to solicit their former customers in the Memphis area and reenter the business. In fact, before petitioners could collect the sums payable under the covenant, they were required to file affidavits attesting to the fact that they had not reentered the market (R. 280a).

The Tax Court concluded that the restrictive covenant had economic substance and was bargained for separately from the sale of the partnership interests (R. 292a-295a). The court of appeals added that "This record leaves no doubt that the covenants not to compete had real economic value for the purchaser" (Pet. 3a). Petitioners are here seeking a further appellate review of this factual issue as to which both lower courts were in agreement.

2. There is no conflict of decisions. While the courts of appeals have varied the language used to enunciate the legal standard applied in cases like the instant one, they all apply substantially the same test. Where, as a part of selling his business, a taxpayer enters into a contract which states a separate amount to be paid for a covenant not to compete, the courts all regard the amount so designated as being the consideration for the covenant (and thus ordinary income), unless the taxpayer introduces strong evidence showing that the covenant had no economic reality and that the amount was really an additional, disguised payment for the business. In making this inquiry the courts look to all of the facts and circumstances surrounding the transaction. The only difference between the courts is one of emphasis in phrasing the legal test.

In the instant case, the lower courts examined all of the relevant facts and concluded that petitioners had not proven that the covenant lacked economic significance. It is apparent that the result would have been the same if the instant case had arisen in any other circuit.[3]

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[3] Nor were petitioners deprived of any substantial rights when the testimony of a revenue agent was excluded as evidence (R. 177a-179a), since his testimony would not have been relevant in ascertaining whether the covenant had economic significance and, by petitioners' own admission (R. 178a), his determinations could not have estopped the Commissioner.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.

MITCHELL ROGOVIN,
Assistant Attorney General.

DAVID O. WALTER,
HOWARD J. FELDMAN,
Attorneys.

OCTOBER, 1966.

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